Revenue Ruling 91-26; 1991-1 CB 184

March 26, 1991

[Code Sec. 1372. Also, Code Secs. 106, 162 and 707]

Partnerships: Rules to apply: Fringe benefit purposes

Accident and health insurance premiums paid by a partnership on behalf of a partner and/or premiums paid by an S corporation on behalf of a 2-percent shareholder-employee are not excludable from gross income. However, provided all the requirements of Code Sec. 162 are met, the partner or shareholder-employee may deduct the cost of the premiums.

TEXT: ISSUES

1. If a partner performs services in the capacity of a partner and the partnership pays accident and health insurance premiums for current year coverage on behalf of such partner without regard to partnership income, what is the Federal income tax treatment of the premium payments?

2. If an S corporation pays accident and health insurance premiums for current year coverage on behalf of a 2-percent shareholder-employee, what is the Federal income tax treatment of the premium payments?

FACTS

Situation 1. AB is a partnership in which individuals A and B are equal partners. During 1989, AB paid accident and health insurance premiums for 1989 coverage on behalf of each partner under AB's accident and health plan.

The premiums paid by AB on behalf of A and B were for services rendered by A and B in their capacities as partners and were payable without regard to partnership income. The premiums paid by AB would qualify as ordinary and necessary business expenses under *section 162(a) of the Code* if paid by AB on behalf of individuals who were not partners of AB. The value of the premiums to A and B is equal to the cost of the premiums paid on behalf of A and B, respectively.

Situation 2. X corporation made a valid election to be an S corporation under *section 1362 of the Code* effective for its taxable year beginning January 1, 1989. Three individuals own X's stock in the following proportions: C, 51 percent; D, 48 percent; and E, 1 percent. C, D, and E are also employees of X.

During 1989, X paid accident and health insurance premiums for 1989 coverage on behalf of each of its employees under X's accident and health plan. The premiums paid by X would qualify as ordinary and necessary business expenses under *section 162(a) of the Code* if paid by X on behalf of individuals who were not "2-percent shareholders." The value of the premiums to C, D, and E is equal to the cost of the premiums paid on behalf of C, D, and E, respectively.

LAW AND ANALYSIS

Section 106 of the Code excludes from the gross income of an employee coverage provided by an employer under an accident or health plan.

Section 162(l) of the Code allows as a deduction, in the case of an individual who is an employee within the meaning of section 401(c)(1), an amount equal to 25 percent of the amount paid during the taxable year for insurance that constitutes medical care for the individual and the individual's spouse and dependents. This provision applies to taxable years beginning after December 31, 1986, and before January 1, 1992.

Section 401(c)(1) of the Code treats certain self-employed individuals as employees. Section 401(c)(1)(B) defines a "self-employed individual," with respect to any taxable year, as an individual who has earned income (as defined in section 401(c)(2)) for the taxable year. Section 401(c)(2) defines "earned income" as, in general, the net earnings from self-employment as defined in section 1402(a). Under section 1402(a), the term net earnings from self-employment is defined to include, with certain specified exceptions, a partner's distributive share of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership in which the individual is a partner. Guaranteed payments to a partner for services also are included in net earnings from self-employment. In addition, section 162(l)(5)(A) provides that, for purposes of section 162(l), if a shareholder owns more than 2 percent of the outstanding stock of an S corporation, the shareholder's wages (as defined in section 3121) from the S corporation are treated as "earned income" within the meaning of section 401(c)(1).

Situation 1. *Section 707(c) of the Code* provides that payments to a partner for services, to the extent the payments are determined without regard to the income of the partnership, are considered as made to one who is not a member of the partnership, but only for purposes of section 61(a) (relating to gross income) and, subject to section 263 (prohibiting deductions for capital expenditures), for purposes of section 162(a) (relating to trade or business expenses). These payments are termed "guaranteed payments."

Section 1.707-1(c) of the Income Tax Regulations provides that for a guaranteed payment under *section 707(c) of the Code* to be deductible by the partnership, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who was not a member of the partnership. Generally, for purposes of Code provisions other than sections 61(a) and 162(a), guaranteed payments are treated as a partner's distributive share of ordinary income. The regulation states, by way of an illustration, that a partner who receives guaranteed payments is not entitled to exclude them from gross income as disability payments under section 105(d) (as in effect prior to its repeal by section 122(b) of the Social Security Amendments of 1983, Pub. L. No. 98-21, *1983-2 C.B. 309, 315).* The regulation also provides that a partner who receives guaranteed payments is not, by virtue of the payments, regarded as an employee of the partnership for purposes of withholding of tax at source, deferred compensation plans, and other purposes.

Amounts paid in cash or in kind by a partnership, without regard to its income, to or for the benefit of its partners, for services rendered in their capacities as partners, are guaranteed payments under *section 707(c) of the Code*. A partnership is entitled to deduct such cash amounts, or the cost to the

partnership of such in-kind benefits, under section 162(a), if the requirements of that section are satisfied (taking into account the rules of section 263). Under section 61(a), the cash amount or the value of the benefit is included in the income of the recipient-partner. The cash amount or value of the benefit is not excludible from the partner's gross income under the general fringe benefit rules (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners) because the benefit is treated as a distributive share of partnership income under *section 1.707-1(c) of the regulations* for purposes of all Code sections other than sections 61(a) and 162(a), and a partner is treated as self-employed to the extent of his or her distributive share of income. Section 1402(a). See also *Rev. Rul. 69-184, 1969-1 C.B. 256* (employment taxes); cf. section 401(c), which recognizes that partners are self-employed individuals but treats them as employees for certain limited purposes.

Therefore, AB may deduct under *section 162(a) of the Code* (subject to section 263) the cost of the accident and health insurance premiums paid on behalf of A and B. A and B may not exclude the cost of the premiums from their gross income under section 106, but must include the cost of the premiums in gross income under section 61(a). Provided all the requirements of section 162(l) are met, however, A and B may deduct the cost of the premiums to the extent provided by section 162(l).

A partnership may account for accident and health insurance premiums paid on behalf of a partner as a reduction in distributions to the partner. Under these circumstances, the premiums are not deductible by the partnership, so distributive shares of partnership income and deduction (and other payment items) are not affected by payment of the premiums. A partner may deduct the cost of the premiums paid on that partner's behalf to the extent allowed under section 162(l).

Situation 2. *Section 1372 of the Code* provides that, for purposes of applying the income tax provisions of the Code relating to employee fringe benefits, an S corporation shall be treated as a partnership, and any person who is a "2-percent shareholder" of the S corporation shall be treated like a partner of a partnership. Section 1372(b) defines a "2-percent shareholder" as any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2 percent of the outstanding stock of the corporation or stock possessing more than 2 percent of the total combined voting power of all stock in the corporation.

Under *section 1372 of the Code*, for purposes of applying the provisions of the Code relating to employee fringe benefits, a 2-percent shareholder who is also an employee of an S corporation is treated like a partner of a partnership. Employee fringe benefits paid or furnished by an S corporation to or for the benefit of its 2-percent shareholder-employees in consideration for services rendered, therefore, are treated for income tax purposes like partnership guaranteed payments under section 707(c). An S corporation is entitled to deduct the cost of such employee fringe benefits under section 162(a) if the requirements of that section are satisfied (taking into account the rules of section 263). Like a partner, a 2-percent shareholder is required to include the value of such benefits in gross income under section 61(a) and is not entitled to exclude such benefits from gross income under provisions of the Code permitting the exclusion of employee fringe benefits (except to the extent the Code provision allowing exclusion of a fringe benefit specifically provides that it applies to partners).

Therefore, X may deduct under *section 162(a) of the Code* the cost of the accident and health insurance premiums paid on behalf of C, D, and E. C and D may not exclude the cost of the premiums from their gross income under section 106, but must include the cost of the premiums in gross income under section 61(a). Provided all the requirements of section 162(l) are met, however, C and D may deduct the cost of the premiums to the extent provided by section 162(l). E (who does not own more than 2 percent of X's stock) may exclude from gross income under section 106 the cost of the premiums paid by X on E's behalf.

Unlike a partnership, an S corporation may not account for accident and health insurance premiums paid on behalf of a shareholder-employee as a reduction in distributions to the shareholder-employee because the shareholder-employee's pro rata share of S corporation income would not be subject to employment taxes.

HOLDINGS

1. Accident and health insurance premiums paid by a partnership on behalf of a partner are guaranteed payments under *section 707(c) of the Code* if the premiums are paid for services rendered in the capacity of partner and to the extent the premiums are determined without regard to partnership income. As guaranteed payments, the premiums are deductible by the partnership under section 162 (subject to the capitalization rules of section 263) and includible in the recipient-partner's gross income under section 61. The premiums are not excludible from the recipient-partner's gross income under section 106; however, provided all the requirements of section 162(l) are met, the partner may deduct the cost of the premiums to the extent provided by section 162(l).

A partnership must report the cost of accident and health insurance premiums that are guaranteed payments on its U.S. Partnership Return of Income (Form 1065) and the Schedule K-1s. A partnership is not required to file a Form 1099 or a Wage and Tax Statement (Form W-2) for accident and health insurance premiums that are guaranteed payments.

2. Under *section 1372 of the Code*, accident and health insurance premiums paid by an S corporation on behalf of a 2-percent shareholder-employee as consideration for services rendered are treated like guaranteed payments under *section 707(c) of the Code*. Therefore, the premiums are deductible by the corporation under section 162 (subject to the capitalization rules of section 263), and includible in the recipient shareholder-employee's gross income under section 61. The premiums are not excludible from the recipient shareholder-employee's gross income under section 106; however, provided all the requirements of section 162(l) are met, the shareholder-employee may deduct the cost of the premiums to the extent provided by section 162(l).

An S corporation may deduct as salary and wages accident and health insurance premiums paid on behalf of its 2-percent shareholder-employees on its U.S. Income Tax Return for an S Corporation. The S corporation is required to file a Wage and Tax Statement (Form W-2) for each 2-percent shareholder-employee. The Form W-2 must include for a 2-percent shareholder-employee the cost of accident and health insurance premiums paid on behalf of the shareholder-employee in the shareholder-employee's wages.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 72-596, 1972-2 C.B. 395, concerns the deductibility under section 162 of the Code of premiums paid by a partnership on behalf of its partners for workmen's compensation insurance. *Rev. Rul. 72-596* relies on the general rule that a partner is not an employee and suggests that workmen's compensation premiums are deductible by the partnership only if paid on behalf of an employee.

The partners in *Rev. Rul. 72-596* were acting in their capacities as partners and the workmen's compensation premiums were payable without regard to partnership income. Thus, the premiums are guaranteed payments under *section 707(c) of the Code*, and as such are deductible by the partnership under section 162 (if the requirements of that section are satisfied) and includible in the incomes of the partners under section 61. *Rev. Rul. 72-596* is incorrect to the extent it concludes otherwise. *Rev. Rul. 72-596* is revoked.

ADMINISTRATIVE RELIEF

For S corporation tax years beginning before January 1, 1991, the Service will not challenge the treatment of accident and health insurance premiums paid by S corporations for 2-percent shareholder-employees in accordance with the instructions to the Form 1120S and Schedule K-1 to the Form 1120S. These instructions provide that such fringe benefits are nondeductible by the S corporation and cannot be treated as deductible or excludible employee fringe benefits (except for benefits allowed partners, such as section 162(1)).

The Service does not consider payments of accident and health insurance premiums by an S corporation on behalf of 2-percent shareholder-employees to be distributions for purposes of the single class of stock requirement of section 1361(b)(1)(D).

DRAFTING INFORMATION

The principal author of this revenue ruling is Christine Ellison of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling contact Christine Ellison on (202) 377-9667 (not a toll-free call).

Rev. Rul. 88-76, 1988-2 C.B. 360

Section 7701. -- Definitions

26 CFR 301.7701-1: Classification of organizations for tax purposes.

July, 1988

Partnership classification. An unincorporated organization operating under the Wyoming Limited Liability Company Act is classified as a partnership for federal tax purposes under section 301.7701-2 of the regulations.

ISSUE

Whether a Wyoming limited liability company, none of whose members or designated managers are personally liable for any debts of the company, is classified for federal tax purposes as an association or as a partnership.

FACTS

M was organized as a limited liability company pursuant to the provisions of the Wyoming Limited Liability Company Act (Act). The purpose of M is to acquire, own, and operate improved real property. M has 25 members, including A, B, and C.

The Act provides that a limited liability company may be managed by a designated manager or managers, or by its members. If the limited liability company is managed by its members, management authority is vested in its members in proportion to their capital contributions to the company. M is managed by its designated managers, A, B, and C.

Under the Act, neither the members nor the designated managers of a limited liability company are liable for any debts, obligations, or liabilities of the limited liability company.

The Act also provides that the interest of a member in a limited liability company is part of the personal estate of the member; however, each member can assign or transfer the member's respective interest in the limited liability company only upon the unanimous written consent of all the remaining members. In the event that the remaining members fail to approve the assignment or transfer, the assignee or transferee has no right to participate in the management or become a member of the limited liability company. However, the assignee or transferee is entitled to receive the share of profits or other compensation and the return of contributions to which the transferring member would otherwise be entitled.

A limited liability company formed under the Act is dissolved upon the occurrence of any of the following events: (1) when the period fixed for the duration of the company expires; (2) by the unanimous written consent of all the members; or (3) by the death, retirement, resignation,

expulsion, bankruptcy, dissolution of a member or occurrence of any other event that terminates the continued membership of a member, unless the business of the company is continued by the consent of all the remaining members under a right to do so stated in the articles of organization of the company. Under M's articles of organization, the business of M is continued by the consent of all the remaining members.

LAW AND ANALYSIS

Section 7701(a)(2) of the Internal Revenue Code provides that the term "partnership" includes a syndicate, group, pool, venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust or estate or a corporation.

Section 7701(a)(3) of the Code provides that the term "corporation" includes associations, joint-stock companies, and insurance companies.

Section 301.7701-1(b) of the Procedure and Administration Regulations states that the Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, that are to be applied in determining the classification of an organization are set forth in sections301.7701-2 through 301.7701-4.

Section 301.7701-2(a)(1) of the regulations sets forth the following basic characteristics of a corporation: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics. In addition to the six major characteristics, other factors may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust.

Section 301.7701-2(a)(2) of the regulations further provides that characteristics common to partnerships and corporations are not material in attempting to distinguish between an association and a partnership. Since associates and an objective to carry on business and divide the gains therefrom are generally common to corporations and partnerships, the determination of whether an organization which has such characteristics isto be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

Section 301.7701-2(a)(3) of the regulations provides that if an unincorporated organization possesses more corporate characteristics than noncorporate characteristics, it constitutes an association taxable as a corporation.

In interpreting section 301.7701-2 of the regulations, the Tax Court, in *Larson v. Commissioner, 66 T.C. 159 (1976),* acq., *1979-1 C.B. 1,* concluded that equal weight must be given to each of the

four corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

In the present situation, M has associates and an objective to carry on business and divide the gains therefrom. Therefore, M must be classified as either an association or a partnership. M is classified as a partnership for federal tax purposes unless the organization has a preponderance of the remaining corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

Section 301.7701-2(b)(1) of the regulations provides that if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. Section 301.7701-2(b)(2) provides that an agreement by which an organization is established may provide that the business will be continued by the remaining members in the event of the death or withdrawal of any member, but such agreement does not establish continuity of life if under local law the death or withdrawal of any member causes a dissolution of the organization.

Under the Act, unless the business of M is continued by the consent of all the remaining members, M is dissolved upon the death, retirement, resignation, expulsion, bankruptcy, dissolution of a member or occurrence of any other event that terminates the continued membership of a member in the company. If a member of M ceases to be a member of M for any reason, the continuity of M's not assured, because all remaining members must agree to continue the business. Consequently, M lacks the corporate characteristic of continuityof life.

Under section 301.7701-2(c)(1) of the regulations an organization has the corporate characteristic of centralized management if any person (or group of persons that does not include all the members) has continuing exclusive authority to make management decisions necessary to the conduct of the business for which the organization was formed.

Under the Act, a limited liability company has the discretion to be managed either by a designated manager or managers, or to be managed by its members. Because M is managed by its designated managers, A, B, and C, M possesses the corporate characteristic of centralized management.

Section 301.7701-2(d)(1) of the regulations provides that an organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of, or claims against, the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim.

Under the Act, neither the managers nor the members of M are personally liable for its debts and obligations. Consequently, M possesses the corporate characteristic of limited liability.

Under section 301.7701-2(e)(1) of the regulations, an organization has the corporate characteristic of free transferability of interests if each of the members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the

organization. In order for this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon the member's substitute all the attributes of the member's interest in the organization. The characteristic of free transferability does not exist if each member can, without the consent of the other members, assign only the right to share in the profits but cannot assign the right to participate in the management of the organization.

Under the terms of the Act, a member of M can assign or transfer that member's interest to another who is not a member of the organization. However, the assignee or transfereedoes not become a substitute member and does not acquire all the attributes of the member's interest in M unless all the remaining members approve the assignment or transfer. Therefore, M lacks the corporate characteristic of free transferability of interests.

M has associates and an objective to carry on business and divide the gains therefrom. In addition, M possesses the corporate characteristic of centralized management and limited liability. M does not, however, possess the corporate characteristics of continuity of life and free transferability of interests.

HOLDING

M has associates and an objective to carry on business and divide the gains therefrom, but lacks a preponderance of the four remaining corporate characteristics. Accordingly, M is classified as a partnership for federal tax purposes.

The Principal author of this revenue ruling is Ann Veninga of the Individual Tax Division. For further information regarding this revenue ruling contact Ms. Veninga on (202) 566-5983 (not a toll-free call).